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# Omnibus proposal of Professional Ethics Division interpretations and rulings; Exposure draft (American Institute of Certified Public Accountants), 1998, Nov. 16

American Institute of Certified Public Accountants. Professional Ethics Executive Committee

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# **EXPOSURE DRAFT**

## **OMNIBUS PROPOSAL OF PROFESSIONAL ETHICS DIVISION INTERPRETATIONS AND RULINGS**

☐ PROPOSED REVISION OF INTERPRETATION 101-3 UNDER RULE 101: *Provision of Other ~~Accounting~~ Services to Clients* ☐ PROPOSED RULING UNDER RULE 101 AND RULE 102: Member Is Connected With an Entity That Has a Loan to a Client ☐ PROPOSED REVISION OF INTERPRETATION 102-1 UNDER RULE 102: Knowing Misrepresentations in the Preparation of Financial Statements or Records ☐ PROPOSED RULING UNDER RULE 302: Investment Advisory Services ☐ PROPOSED RULING UNDER RULE 302 AND RULE 503: Commission and Contingent Fee Arrangements With Nonattest Client ☐ PROPOSED REVISION OF INTERPRETATION 501-4 UNDER RULE 501: Negligence in the Preparation of Financial Statements or Records ☐ PROPOSED INTERPRETATION UNDER RULE 501: Failure to File Tax Return or Pay Tax Liability ☐ PROPOSED DELETION OF INTERPRETATION 505-1 UNDER RULE 505: Investment in Accounting Organization

**NOVEMBER 16, 1998**

**Prepared by the AICPA Professional Ethics Executive Committee for comments from persons interested in independence, behavioral, and technical standards matters**

**Comments should be received by January 15, 1999, and addressed to  
Lisa A. Snyder, Director, Professional Ethics Division,  
AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.**

**800125**

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Any individual or organization may obtain one copy of this document without charge until the end of the comment period by writing to the AICPA Order Department, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

November 16, 1998

This exposure draft contains eight proposals for review and comment by the AICPA's membership and other interested parties regarding pronouncements to be adopted by the Professional Ethics Executive Committee. The text and an explanation of each proposed pronouncement are included in this exposure draft.

A summary does not accompany this exposure draft; instead, the type of information a summary would contain is included in the "Explanation" preceding each proposal.

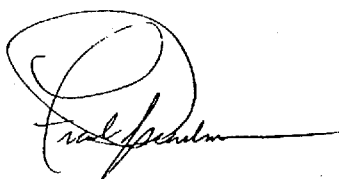
After the exposure period is concluded and the comments have been evaluated by the Professional Ethics Executive Committee, the committee may decide to publish one or more of the proposed pronouncements. Once published, the pronouncements become effective on the last day of the month in which they are published in the *Journal of Accountancy*, except as may otherwise be stated in the pronouncements.

Your comments are an important part of the standard-setting process. Please take this opportunity to comment. Responses must be received at the AICPA by January 15, 1999. All written replies to this exposure draft will become part of the public record of the AICPA and will be available for inspection at the office of the AICPA after February 26, 1999, for a period of one year.

All comments received will be considered by the Professional Ethics Executive Committee at an open meeting. Once scheduled, notice of the meeting will be published in the *CPA Letter* and on the Institute's Web site at <http://www.aicpa.org/members/div/ethics/index.htm>.

Please send comments to Lisa A. Snyder, Director, AICPA Professional Ethics Division, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 or [lsnyder@aicpa.org](mailto:lsnyder@aicpa.org).

Sincerely,



Frank J. Pearlman  
Chair  
AICPA Professional Ethics  
Executive Committee



Lisa A. Snyder  
Director  
AICPA Professional  
Ethics Division

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## **PROPOSED REVISION OF INTERPRETATION 101-3 UNDER RULE 101**

### *[Explanation]*

The Professional Ethics Executive Committee is proposing a revision of Interpretation 101-3 under Rule 101, *Independence* [ET section 101.05], to address the various types of nonattest services that a member may perform for an attest client in today's practice environment and the impact of such services on the member's independence. The proposal sets forth general principles that the member should consider in evaluating the effect on independence of performing a service, and provides examples of general activities that would be considered to impair independence. Several examples follow that apply the general principles and activities to specific services.

In general, a member's independence would not be considered impaired provided the member does not perform any management functions or make management decisions for the attest client. As revised, the Interpretation would permit a member to make electronic payroll tax payments through the Electronic Federal Tax Payment System for an attest client without impairing his or her independence, provided the client has made arrangements for the financial institution to limit such payments to a named payee.

If adopted, the committee would delete the following ethics rulings under rule 101 because they are incorporated into the revised Interpretation: Ruling no. 3, *Member as Signer or Cosigner of Checks* [ET section 191.005-.006], Ruling no. 4, *Payroll Preparation Services* [ET section 191.007-.008], Ruling no. 7, *Member Providing Contract Services* [ET section 191.013-.014], Ruling no. 39, *Member as Officially Appointed Stock Transfer Agent or Registrar* [ET section 191.077-.078], Ruling no. 51, *Member Providing Legal Services* [ET section 191.101-.102], Ruling no. 54, *Member Providing Appraisal, Valuation or Actuarial Services* [ET section 191.107-.108], Ruling no. 55, *Independence During Systems Implementation* [ET section 191.109-.110], and Ruling no. 56, *Executive Search* [ET section 191.111-.112].

The committee is seeking comments on all aspects of the proposal, but specifically requests that respondents address the appropriateness of the general principles and activities. In addition, any suggested additional services where examples would be useful would be welcomed.

### ***Provision of Other Accounting Services to Clients***

*A member in public practice or his or her firm ("member") who performs for a client services requiring independence ("attest services") may also perform other nonattest services ("other services") for that client. When a member performs other services for an attest service client, he or she must evaluate the nature and aggregate impact of such services on his or her independence. In particular, care should be taken not to perform management functions or make management decisions for the attest client, the responsibility for which remains with the client's board of directors and management.*

*In making arrangements to perform other services, the member should establish an understanding with the client regarding the objectives of the engagement, the services to be performed, management's responsibilities, the member's responsibilities, and the limitations of the engagement. It is preferable that this understanding be documented in an engagement letter that indicates the member will not perform management functions or make management decisions. In addition, the member should be satisfied that the client is in a position to have an informed judgment on the results of the other services and that the client understands its responsibility to—*

- 1. Designate a management-level individual or individuals to be responsible for overseeing the services being provided.*
- 2. Evaluate the adequacy of the services performed and any findings that result.*
- 3. Make management decisions, including accepting responsibly for the results of the other services.*
- 4. Establish and maintain internal controls, including monitoring ongoing activities.*

### ***General Activities***

*The following are some general activities that, if performed as part of an engagement to provide other services, would be considered to impair a member's independence:*

- Authorizing, executing or consummating a transaction or otherwise exercising authority on behalf of a client (for example, negotiating a transaction)*
- Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders)*
- Having custody of client assets*
- Supervise client employees in the performance of their regular day to day activities*
- Determine which recommendations of the member should be implemented*

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<sup>1</sup> Strike-through denotes proposed deletions to current text. Proposed new language is in italic.

- Report to the board of directors on behalf of management
- Serve as a client's stock transfer agent, registrar, general counsel or its equivalent

The examples in the following table identify the effect that performance of other services for an attest client can have on a member's independence. These examples are not intended to be all-inclusive of the types of other services performed by members.

<u><b>TYPE OF OTHER SERVICE</b></u>	<u><b>INDEPENDENCE WOULD NOT BE IMPAIRED</b></u>	<u><b>INDEPENDENCE WOULD BE IMPAIRED</b></u>
<i>Bookkeeping</i>	<ul style="list-style-type: none"> <li>• Record transactions for which management has determined or approved the appropriate account classification or post coded transactions to a client's general ledger.</li> <li>• Prepare financial statements based on information in the trial balance.</li> <li>• Prepare and post client approved adjusting or closing entries to a client's trial balance.</li> </ul>	<ul style="list-style-type: none"> <li>• Determine appropriate account classification for transactions without management direction.</li> <li>• Authorize or approve transactions.</li> <li>• Prepare source documents or originate data.</li> </ul>
<i>Payroll and Other Disbursement</i>	<ul style="list-style-type: none"> <li>• Using payroll time reports provided and approved by the client, generate unsigned checks or process client's payroll.</li> <li>• Transmit client payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments in amount and to payee. In addition, once transmitted the client must authorize the financial institution to process the information.</li> <li>• Make electronic payroll tax payments in accordance with the treasury department's guidelines provided the client has made arrangements for their financial institution to limit such payments to a named payee.</li> </ul>	<ul style="list-style-type: none"> <li>• Sign checks or authorize payment of client funds, electronically or otherwise.</li> <li>• Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client.</li> <li>• Sign payroll tax return on behalf of client management.</li> <li>• Approve vendor invoices for payment on the client's behalf.</li> </ul>

**TYPE OF OTHER  
SERVICE**

**INDEPENDENCE WOULD NOT BE  
IMPAIRED**

**INDEPENDENCE WOULD BE  
IMPAIRED**

*Benefit Plan  
Administration*

- *Communicate summary plan data to plan trustee.*
  - *Advise client management regarding the application or impact of provisions of the plan document.*
  - *Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan) initiated by plan participants through the member's electronic medium, such as an interactive voice response system or Internet connection.*
  - *Prepare account valuations for plan participants using data collected through the member's electronic medium.*
  - *Prepare and transmit participant account summaries to plan participants based on data collected through the member's electronic medium.*
- *Make policy decisions on behalf of client management.*
  - *Interpret the plan document on behalf of management when dealing with plan participants.*
  - *Make disbursements on behalf of the plan.*
  - *Have custody of assets of a plan.*

*Investment Advisory  
& Management*

- *Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client's desired rate of return, risk tolerance, etc.*
  - *Perform record keeping and reporting of client's portfolio balances including providing a comparative analysis of the client's investments to third party benchmarks.*
  - *Review the manner in which a client's portfolio is being managed by investment account managers, including determining whether the managers are: (1) following the guidelines of the client's investment policy statement; (2) meeting the client's investment objectives; and, (3) conforming to the client's stated investment styles.*
  - *Transmit a client's investment selection to a broker dealer or equivalent provided the client has authorized the broker dealer or equivalent to execute the transaction.*
- *Make investment decisions on behalf of client management.*
  - *Execute a transaction to buy or sell an investment.*
  - *Have custody of client assets, such as taking temporary possession of securities purchased by a client.*



<b><u>TYPE OF OTHER SERVICE</u></b>	<b><u>INDEPENDENCE WOULD NOT BE IMPAIRED</u></b>	<b><u>INDEPENDENCE WOULD BE IMPAIRED</u></b>
<i>Corporate Finance Consulting or Advisory</i>	<ul style="list-style-type: none"> <li>• Assist in developing corporate strategies.</li> <li>• Assist in identifying sources of capital that meet the client's specifications or criteria.</li> <li>• Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers or capital sources.</li> <li>• Assist in drafting an offering document or memorandum.</li> </ul>	<ul style="list-style-type: none"> <li>• Negotiate with potential investors and capital sources on behalf of client.</li> <li>• Distribute private placement memoranda or offering documents to potential investors.</li> <li>• Act as an underwriter, broker, agent, distributor or guarantor with respect to client securities.</li> <li>• Maintain custody of client securities.</li> </ul>
<i>Appraisal, Valuation or Actuarial</i>	<ul style="list-style-type: none"> <li>• Test the reasonableness of the value placed on an asset or liability included in a client's financial statements by preparing a separate valuation of that asset or liability.</li> <li>• Perform a valuation of a client's business when all significant matters of judgment are determined or approved by the client and the client is in a position to have an informed judgment on the results of this valuation.</li> </ul>	<ul style="list-style-type: none"> <li>• Prepare a valuation of an employer's securities contained in an employee stock ownership plan ( ESOP ) to support transactions with participants, plan contributions, and allocations within the ESOP, when the client is not in a position to have an informed judgment on the results of this valuation.</li> <li>• Prepare an appraisal, valuation or actuarial report using assumptions determined by the member and not approved by the client.</li> </ul>
<i>Executive or Employee Search</i>	<ul style="list-style-type: none"> <li>• Recommend a position description or candidate specifications.</li> <li>• Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g. required skills and experience).</li> </ul>	<ul style="list-style-type: none"> <li>• Negotiate employee compensation and benefits on behalf of client.</li> <li>• Hire and terminate employees on behalf of client.</li> </ul>
<i>Business Risk Consulting</i>	<ul style="list-style-type: none"> <li>• Provide assistance in assessing the client's business risks and control processes.</li> <li>• Develop a plan for making improvements to a client's control processes and assist in implementing these improvements.</li> </ul>	<ul style="list-style-type: none"> <li>• Make or approve business risk decisions on behalf of the client.</li> <li>• Present business risk considerations to the Board or others on behalf of the client.</li> </ul>

**TYPE OF OTHER  
SERVICE**

**INDEPENDENCE WOULD NOT BE  
IMPAIRED**

**INDEPENDENCE WOULD BE  
IMPAIRED**

*Information Systems  
Design, Installation  
& Integration*

- *Design, install or integrate a client's information system, provided the client makes all significant management decisions.*
- *Customize a prepackaged accounting or information system, provided the client makes all significant management decisions.*
- *Provide the initial training and instruction to client employees on a newly implemented information and control system.*

- *Supervise client personnel in the daily operation of a client's information system.*
- *Manage a client's local area network system.*

~~Members in public practice may be asked to provide manual or automated bookkeeping or data processing services to clients. Computer systems design and programming assistance may also be rendered by members either in conjunction with data processing services or as a separate engagement. In addition, members may rent "block time" on their computers to their clients but are not involved in the processing of transactions or maintaining the client's accounting records.~~

~~A member providing such services to a client must meet the following requirements to be considered independent:~~

- ~~1. The client must accept the responsibility for the financial statements as his own. The client must be sufficiently informed of the enterprise's activities and financial condition and the applicable accounting principles so that the client can reasonably accept such responsibility, including, specifically, fairness of "valuation and presentation" and adequacy of disclosure. When necessary, the member must discuss accounting matters with the client to assist the client in understanding such matters.~~
- ~~2. The member must not assume the role of employee or of management. For example, the member shall not consummate transactions, have custody of assets, or exercise authority on behalf of the client. The client must prepare the source documents on transactions in sufficient detail to identify clearly the nature and amount of such transactions. The member should not make changes in such basic data without the concurrence of the client.~~
- ~~3. When financial statements are prepared from books and records which the member has maintained, the member must comply with applicable standards for audits, reviews, or compilations.~~

## PROPOSED RULING UNDER RULE 101 AND RULE 102

### *[Explanation]*

The Professional Ethics Executive Committee proposes the following ethics ruling to provide guidance to AICPA members who are associated with entities that have a loan to a client for whom services are performed requiring independence under rule 101. The committee believes that if the member can control the entity, the entity itself will be considered a member of the firm, as defined in Interpretation 101-9 [ET section 101.11], and independence would be impaired. If the member cannot control the entity, but is connected with the entity as an officer, director, or principal shareholder, the member should consider Interpretation 102-2, *Conflicts of Interest* [ET section 102.03], which may require disclosure of the relationship to and consent from the client and other appropriate parties.

### *[Text of Proposed Ruling Under Rule 101]*

#### **Member Is Connected With an Entity That Has a Loan to a Client**

**Question--** A member is connected with an entity as an officer, director, or principal shareholder, and that entity has a loan to the member's client. Would the independence of the member or member's firm be considered to be impaired with respect to the client?

**Answer--** If a member has control over the entity, as defined in FASB Statement No. 94 [AC section C51], the existence of a loan to the client would impair the independence of the member or member's firm (see Interpretation 101-9 [ET section 101.11]).

If a member who does not control the entity is connected with the entity as an officer, director, or principal shareholder, the member should consider Interpretation 102-2 [ET section 102.03], which provides that a conflict of interest may occur if a member performs a professional service for a client and the member or his or her firm has a relationship with another entity that could, in the member's professional judgment, be viewed by the client or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client and other appropriate parties, the rule shall not operate to prohibit the performance of the professional service.

When making the decision as to whether to perform a professional service and in making disclosure to the appropriate parties, the member should consider Rule 301, *Confidential Client Information* [ET section 301.01].

# PROPOSED REVISION OF INTERPRETATION 102-1 UNDER RULE 102

[*Explanation*]

The Professional Ethics Executive Committee is proposing a revision of Interpretation 102-1 under Rule 102, *Integrity and Objectivity* [ET section 102.02], relating to a member who knowingly misrepresents facts in the preparation of financial statements or records. The proposed revision would expand the Interpretation to include those members who have the authority but fail to correct an entity's financial statements or records, which are known to be materially false and misleading, or who sign a document containing materially false and misleading information.

[*Text of Proposed Revision of Interpretation 102-1*]

## **Knowing Misrepresentations in the Preparation of Financial Statements or Records**

*A member shall have knowingly misrepresented facts in violation of rule 102 [ET section 102.01] when—*

- 1) A member ~~who~~ knowingly makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records ~~shall be considered to have knowingly misrepresented facts in violation of rule 102 [ET section 102.01];~~ or*
- 2) A member who has the authority to record an entry knowingly fails to correct an entity's financial statements or records that are materially false and misleading; or*
- 3) A member knowingly signs a document containing materially false and misleading information.*

## PROPOSED RULING UNDER RULE 302

### *[Explanation]*

The Professional Ethics Executive Committee proposes the following ethics ruling under Rule 302, *Contingent Fees*, to provide guidance to AICPA members who provide investment advisory services for an attest client for a fee based on a percentage of the client's investment portfolio. The proposed ruling would permit a member to enter into such an arrangement with an attest client provided that certain conditions are met.

After careful deliberation, the committee concluded that, absent a renewal no more frequently than quarterly, because the fee is contingent on the result of the service it would be in violation of rule 302. However, under the quarterly renewal arrangement, the client can decide on a quarterly basis not to renew and therefore avoid paying that portion of the fee that was the result of the service (that is, the increase in value of the portfolio). The proposed ruling also refers the member to the independence rules when providing investment advisory services because the performance of services such as managing the client's investment portfolio would impair the member's independence. The committee would welcome comments on its views, as well as any aspects of this service and fee arrangement that might affect those views.

### *[Text of Proposed Ruling Under Rule 302]*

#### **Investment Advisory Services**

**Question**--A member or member's firm ("member") provides investment advisory services for an attest client for a fee based on a percentage of the client's investment portfolio. Would the member be considered to be in violation of Rule 302, *Contingent Fees* [ET section 302.01]?

**Answer**--Yes. However, a member would not violate rule 302 when providing investment advisory services for an attest client if all of the following conditions are met:

1. The fee is based on a percentage of the client's investment portfolio at the beginning of the period and is adjusted only for additions or withdrawals by the client during the period.
2. The fee charged does not vary based on portfolio performance.
3. The fee arrangement is not renewed with the client more frequently than on a quarterly basis.

When performing such services, the member should also consider Rule 101, *Independence* [ET section 101.01] (See proposed revision to Interpretation 101-3 [ET section 101.05].

## **PROPOSED RULING UNDER RULE 302 AND RULE 503**

*[Explanation]*

The Professional Ethics Executive Committee proposes the following ethics ruling under Rule 302, *Contingent Fees*, and Rule 503, *Commissions and Referral Fees*, to provide guidance to AICPA members who provide professional services, such as investment advisory or other consulting services, to the owners or employees of an attest client, or to an employee benefit plan sponsored by an attest client. The committee considers the owners, employees, and benefit plan to be separate clients from the attest client for the purpose of applying rule 302 and rule 503 and therefore permits a member to enter into a contingent fee arrangement with, or refer products or services for a commission to, the owners, employees, or employee benefit plan of an attest client without violating these rules.

*[Text of Proposed Ruling Under Rule 302 and Rule 503]*

### **Commission and Contingent Fee Arrangements With Nonattest Client**

**Question**--A member or member's firm ("member") provides professional services (for example, investment advisory services or other consulting services) for a contingent fee, or refers products or services for a commission, to the owners or employees of an attest client or to a nonattest client employee benefit plan sponsored by the attest client. Would the member be considered to be in violation of rule 302 [ET section 302.01] or rule 503 [ET section 503.01]?

**Answer**--No. The member would not be in violation of rule 302 or rule 503 provided that with respect to rule 503, the member discloses the commission to the owners, employees, or employee benefit plan client. The member should also consider the applicability of Interpretation 102-2, *Conflicts of Interest* [ET section 102.03], and his or her professional responsibility to the client under Rule 301, *Confidential Client Information* [ET section 301.01], when performing such professional services.

## PROPOSED REVISION OF INTERPRETATION 501-4 UNDER RULE 501

### *[Explanation]*

The Professional Ethics Executive Committee is proposing a revision of Interpretation 501-4 under Rule 501, *Acts Discreditable* [ET section 501.05], relating to a member who, because of his or her negligence, makes or permits another to make materially false and misleading entries in an entity's financial statements or records. The proposed revision would expand the Interpretation to include those members who have the authority, but fail to correct an entity's financial statements or records, which are known to be materially false and misleading, or sign a document containing materially false and misleading information.

### *[Text of Proposed Revision of Interpretation 501-4]*

#### **Negligence in the Preparation of Financial Statements or Records**

*A member shall be considered to have committed an act discreditable to the profession in violation of rule 501 [ET section 501.01] when by virtue of his or her negligence—*

- 1) A member ~~who, by virtue of his negligence,~~ makes, or permits or directs another to make, materially false and misleading entries in the financial statements or records of an entity ~~shall be considered to have committed an act discreditable to the profession in violation of rule 501 [ET section 501.01];~~ or*
- 2) A member who has the authority to record an entry fails to correct an entity's financial statements that are materially false and misleading; or*
- 3) A member signs a document containing materially false and misleading information.*

# PROPOSED INTERPRETATION UNDER RULE 501

## *[Explanation]*

The Professional Ethics Executive Committee is proposing an Interpretation under Rule 501, *Acts Discreditable* [ET section 501], relating to a member who fails to timely file his or her personal tax returns or tax returns of the member's firm, including the firm's payroll tax returns and the remittance of related taxes. The committee believes that because the public has associated CPAs with the performance of quality tax services, a member who fails to timely file his or her own or firm's tax returns has discredited the profession. In the case where a member fails to timely file or remit payroll taxes of the firm, the member's actions also constitute a breach of his or her fiduciary responsibility on behalf of firm employees. Accordingly, the Professional Ethics Executive Committee is proposing the following Interpretation to enunciate its position.

## *[Text of Proposed Interpretation Under Rule 501]*

### **Failure to File Tax Return or Pay Tax Liability**

A member who fails to comply with applicable federal or state laws or regulations regarding the timely filing or payment of taxes related to the member's personal tax returns or tax returns of the member's firm, including payroll tax returns and related taxes, may be considered to have committed an act discreditable to the profession in violation of rule 501 [ET section 501.01].



## **PROPOSED DELETION OF INTERPRETATION 505-1 UNDER RULE 505**

*[Explanation]*

The Professional Ethics Executive Committee is proposing a deletion of Interpretation 505-1 under Rule 505, *Form of Organization and Name* [ET section 505.02], relating to a member who has an investment in an entity that practices public accounting through a corporate form. The committee believes that this Interpretation is obsolete and is covered under Interpretation 505-2, *Application of Rules of Conduct to Members Who Own a Separate Business* [ET section 505.03].

*[Text of Interpretation 505-1 Proposed for Deletion]*

### **Investment in Accounting Organization**

A member in the practice of public accounting may have an unlimited investment in an accounting organization as long as the practice of public accounting through that form of organization is permitted by state law or regulation and the organization's characteristics conform to the resolution of council. If the practice of public accounting through a corporate form is not permitted by state law or regulation, the member may invest in the corporation. However, the member's relation to the corporation must be solely that of an investor, and the investment cannot allow the member significant influence over the corporation. [Replaces previous Interpretation 505-1, *Investment in Commercial Accounting Corporation*, March 1993, effective March 31, 1993.]